

or to convert the proceeds into a qualified annuity interest. The trustee elects the latter option. The amount of the annuity is the amount of the annuity that would be payable if no portion of the sale proceeds had been reinvested in a personal residence multiplied by a fraction. The numerator of the fraction is \$60,000 (the amount remaining after reinvestment) and the denominator of the fraction is \$260,000 (the fair market value of the trust assets on the conversion date). The obligation to pay the annuity commences on the date of sale, but payment of the annuity that otherwise would have been payable during the period between the date of sale and the date on which the trust ceased to be a qualified personal residence trust with respect to the excess proceeds may be deferred until 30 days after the date on which the new residence is purchased. Any amount deferred must bear compound interest from the date the annuity is payable at the section 7520 rate in effect on the date of sale. The \$15,000 of income distributed to the term holder during that period may be used to reduce the annuity amount payable with respect to that period if the governing instrument so provides and thus reduce the amount on which compound interest is computed.

[T.D. 8395, 57 FR 4269, Feb. 4, 1992; T.D. 8395, 57 FR 11265, Apr. 2, 1992, as amended by T.D. 8743, 62 FR 66988, Dec. 23, 1997]

§ 25.2702-6 Reduction in taxable gifts.

(a) *Transfers of retained interests in trust*—(1) *Inter vivos transfers*. If an individual subsequently transfers by gift an interest in trust previously valued (when held by that individual) under § 25.2702-2 (b)(1) or (c), the individual is entitled to a reduction in aggregate taxable gifts. The amount of the reduction is determined under paragraph (b) of this section. Thus, for example, if an individual transferred property to an irrevocable trust, retaining an interest in the trust that was valued at zero under § 25.2702-2(b)(1), and the individual later transfers the retained interest by gift, the individual is entitled to a reduction in aggregate taxable gifts on the subsequent transfer. For purposes of this section, aggregate taxable gifts means the aggregate sum of the individual's taxable gifts for the calendar year determined under section 2502(a)(1).

(2) *Testamentary transfers*. If either—

(i) A term interest in trust is included in an individual's gross estate solely by reason of section 2033, or

(ii) A remainder interest in trust is included in an individual's gross estate, and the interest was previously valued (when held by that individual) under § 25.2702-2(b)(1) or (c), the individual's estate is entitled to a reduction in the individual's adjusted taxable gifts in computing the Federal estate tax payable under section 2001. The amount of the reduction is determined under paragraph (b) of this section.

(3) *Gift splitting on subsequent transfer*. If an individual who is entitled to a reduction in aggregate taxable gifts (or adjusted taxable gifts) subsequently transfers the interest in a transfer treated as made one-half by the individual's spouse under section 2513, the individual may assign one-half of the amount of the reduction to the consenting spouse. The assignment must be attached to the Form 709 on which the consenting spouse reports the split gift.

(b) *Amount of reduction*—(1) *In general*. The amount of the reduction in aggregate taxable gifts (or adjusted taxable gifts) is the lesser of—

(i) The increase in the individual's taxable gifts resulting from the interest being valued at the time of the initial transfer under § 25.2702-2(b)(1) or (c); or

(ii) The increase in the individual's taxable gifts (or gross estate) resulting from the subsequent transfer of the interest.

(2) *Treatment of annual exclusion*. For purposes of determining the amount under paragraph (b)(1)(ii) of this section, the exclusion under section 2503(b) applies first to transfers in that year other than the transfer of the interest previously valued under § 25.2702-2(b)(1) or (c).

(3) *Overlap with section 2001*. Notwithstanding paragraph (b)(1) of this section, the amount of the reduction is reduced to the extent section 2001 would apply to reduce the amount of an individual's adjusted taxable gifts with respect to the same interest to which paragraph (b)(1) of this section would otherwise apply.

(c) *Examples*. The rules of this section are illustrated by the following examples. The following facts apply for *Examples 1-4*:

Facts. In 1992, X transferred property to an irrevocable trust retaining the right to receive the trust income for life. On the death of X, the trust is to terminate and the trust corpus is to be paid to X's child, C. X's income interest had a value under section 7520 of \$40,000 at the time of the transfer; however, because X's retained interest was not a qualified interest, it was valued at zero under § 25.2702-2(b)(1) for purposes of determining the amount of X's gift. X's taxable gifts in 1992 were therefore increased by \$40,000. In 1993, X transfers the income interest to C for no consideration.

Example 1. Assume that the value under section 7520 of the income interest on the subsequent transfer to C is \$30,000. If X makes no other gifts to C in 1993, X is entitled to a reduction in aggregate taxable gifts of \$20,000, the lesser of the amount by which X's taxable gifts were increased as a result of the income interest being valued at zero on the initial transfer (\$40,000) or the amount by which X's taxable gifts are increased as a result of the subsequent transfer of the income interest (\$30,000 minus \$10,000 annual exclusion).

Example 2. Assume that in 1993, 4 months after X transferred the income interest to C, X transferred \$5,000 cash to C. In determining the increase in taxable gifts occurring on the subsequent transfer, the annual exclusion under section 2503(b) is first applied to the cash gift. X is entitled to a reduction in aggregate taxable gifts of \$25,000, the lesser of the amount by which X's taxable gifts were increased as a result of the income interest being valued at zero on the initial transfer (\$40,000) or the amount by which X's taxable gifts are increased as a result of the subsequent transfer of the income interest (\$25,000 ((\$30,000+\$5,000) – \$10,000 annual exclusion)).

Example 3. Assume that the value under section 7520 of the income interest on the subsequent transfer to C is \$55,000. X is entitled to reduce aggregate taxable gifts by \$40,000, the lesser of the amount by which X's taxable gifts were increased as a result of the income interest being valued at zero on the initial transfer (\$40,000) or the amount by which X's taxable gifts are increased as a result of the subsequent transfer of the income interest (\$55,000 minus \$10,000 annual exclusion = \$45,000).

Example 4. Assume that X and X's spouse, S, split the subsequent gift to C. X is entitled to assign one-half the reduction to S. If the assignment is made, each is entitled to reduce aggregate taxable gifts by \$17,500, the lesser of their portion of the increase in taxable gifts on the initial transfer by reason of the application of section 2702 (\$20,000) and their portion of the increase in taxable gifts on the subsequent transfer of the retained interest (\$27,500 – \$10,000 annual exclusion).

Example 5. In 1992, A transfers property to an irrevocable trust, retaining the right to receive the trust income for 10 years. On the expiration of the 10-year term, the trust is to terminate and the trust corpus is to be paid to A's child, B. Assume that A's term interest has a value under section 7520 of \$20,000 at the time of the transfer; however, because A's retained interest was not a qualified interest, it was valued at zero under § 25.2702-2(b)(1) for purposes of determining the amount of A's gift. Assume also that A and A's spouse, S, split the gift of the remainder interest under section 2513. In 1993, A transfers A's term interest to D, A's other child, for no consideration. A is entitled to reduce A's aggregate taxable gifts on the transfer. Assume that A and S also split the subsequent gift to D, and that A dies one month after making the subsequent transfer of the term interest and S dies six months later. The gift of the term interest is included in A's gross estate under section 2035(d)(2). To the extent S's taxable gifts are reduced pursuant to section 2001(e), S is entitled to no reduction in aggregate or adjusted taxable gifts under this section.

Example 6. T transfers property to an irrevocable trust retaining the power to direct the distribution of trust income for 10 years among T's descendants in whatever shares T deems appropriate. On the expiration of the 10-year period, the trust corpus is to be paid in equal shares to T's children. T's transfer of the remainder interest is a completed gift. Because T's retained interest is not a qualified interest, it is valued at zero under § 25.2702-2(b)(1) and the amount of T's gift is the fair market value of the property transferred to the trust. The distribution of income each year is not a transfer of a retained interest in trust. Therefore, T is not entitled to reduce aggregate taxable gifts as a result of the distributions of income from the trust.

Example 7. The facts are the same as in Example 6, except that after 3 years T exercises the right to direct the distribution of trust income by assigning the right to the income for the balance of the term to T's child, C. The exercise is a transfer of a retained interest in trust for purposes of this section. T is entitled to reduce aggregate taxable gifts by the lesser of the increase in taxable gifts resulting from the application of section 2702 to the initial transfer or the increase in taxable gifts resulting from the transfer of the retained interest in trust.

Example 8. In 1992, V purchases an income interest for 10 years in property in the same transaction or series of transactions in which G, V's child, purchases the remainder interest in the same property. V dies in 1997 still holding the term interest, the value of which is includible in V's gross estate under section 2033. V's estate would be entitled to a reduction in adjusted taxable gifts in the

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amount determined under paragraph (b) of this section.

[T.D. 8395, 57 FR 4272, Feb. 4, 1992]

§ 25.2702-7 Effective dates.

Except as provided in this section, §§ 25.2702-1 through 25.2702-6 apply as of January 28, 1992. With respect to transfers to which section 2702 applied made prior to January 28, 1992, taxpayers may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of the proposed regulations and the final regulations are considered a reasonable interpretation of the statutory provisions. The fourth through eighth sentences of § 25.2702-5(b)(1) and § 25.2702-5(c)(9) apply with respect to trusts created after May 16, 1996.

[T.D. 8395, 57 FR 4273, Feb. 4, 1992, as amended by T.D. 8743, 62 FR 66989, Dec. 23, 1997]

§ 25.2703-1 Property subject to restrictive arrangements.

(a) *Disregard of rights or restrictions—*

(1) *In general.* For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), the value of any property is determined without regard to any right or restriction relating to the property.

(2) *Right or restriction.* For purposes of this section, right or restriction means—

(i) Any option, agreement, or other right to acquire or use the property at a price less than fair market value (determined without regard to the option, agreement, or right); or

(ii) Any restriction on the right to sell or use the property.

(3) *Agreements, etc. containing rights or restrictions.* A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement. A right or restriction may be implicit in the capital structure of an entity.

(4) *Qualified easements.* A perpetual restriction on the use of real property that qualified for a charitable deduction under either section 2522(d) or section 2055(f) of the Internal Revenue Code is not treated as a right or restriction.

(b) *Exceptions—*(1) *In general.* This section does not apply to any right or

restriction satisfying the following three requirements—

(i) The right or restriction is a bona fide business arrangement;

(ii) The right or restriction is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth; and

(iii) At the time the right or restriction is created, the terms of the right or restriction are comparable to similar arrangements entered into by persons in an arm's length transaction.

(2) *Separate requirements.* Each of the three requirements described in paragraph (b)(1) of this section must be independently satisfied for a right or restriction to meet this exception. Thus, for example, the mere showing that a right or restriction is a bona fide business arrangement is not sufficient to establish that the right or restriction is not a device to transfer property for less than full and adequate consideration.

(3) *Exception for certain rights or restrictions.* A right or restriction is considered to meet each of the three requirements described in paragraph (b)(1) of this section if more than 50 percent by value of the property subject to the right or restriction is owned directly or indirectly (within the meaning of § 25.2701-6) by individuals who are not members of the transferor's family. In order to meet this exception, the property owned by those individuals must be subject to the right or restriction to the same extent as the property owned by the transferor. For purposes of this section, members of the transferor's family include the persons described in § 25.2701-2(b)(5) and any other individual who is a natural object of the transferor's bounty. Any property held by a member of the transferor's family under the rules of § 25.2701-6 (without regard to § 25.2701-6(a)(5)) is treated as held only by a member of the transferor's family.

(4) *Similar arrangement—*(i) *In general.* A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been